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Beware the "One Size Fits All" Plan for Valuations

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Investment bankers are often asked to counsel clients regarding business valuation topics.

There is a temptation to use historical costs, such as book value businesses. Over the past 15 years, however, business valuation has become a specialization with its own language and procedures, especially as it relates to privately-held stock appraisals. This column will describe some of the major issues regarding a business valuation, and show some peculiarities that surround its practice.

Business interests in this column will be defined as any portion of a privately-held company's stock. The fair market value of a business interest is the price at which it would change hands between willing buyer and a willing seller when the former is not under any compulsion to sell, with both parties having reasonable knowledge of relevant facts. Any attempt to value an interest is really an effort to model or estimate the participant's behavior.

The first step in the process is to define what is being valued, and for what purpose. There are many legitimate reasons for valuing a business interest-for estate planning, to help settle shareholder disputes, or to value an entire business before a sale.

Adjusted Financials

Most privately held businesses operate for the financial gain of their shareholders. The owner's personal life is often merged with the business such that it can be difficult to determine true business earnings.

Thus, the next step in valuing a business is to reconstruct the financial statements of the company to make them independent of the owner and of the unusual circumstances. Since earning power is the most important element in most business valuations, these "adjustments" are made mainly to the income statement and identify those expenses that are either unnecessary to operate the business or unusual and not part of the normal ongoing business operation.

The income statement and balance sheet are interdependent though, so some variables adjusted for income statement analysis imply adjustments to the balance sheet. By properly adjusting the financial statements, a "true" stream of earnings can be calculated and used in valuing the business.

The adjustments are either added to or subtracted from net income to arrive at the adjusted earnings. Net income is increased by the owner's discretionary expenses (salary or bonus, personal expenses charged to the business, etc.). Profits are further adjusted by unusual items, (proceeds from insurance policy, gain/loss on sale of equipment or property, etc.) Due to the possible fluctuations caused by these adjustments, it is customary to show an average of five year's adjusted figures to normalize the numbers.

Past or Future

After adjusting the financial statements, a valuation approach must be chosen. Either historical or forward-looking approaches can be used as the basis for the valuation. Historical approaches are most often used to value small to medium-sized business interest. Proponents of these approaches argue that past or current earnings best reflect the future earnings potential of the company.

Theoretically, though, the values of any business is the value of the firm's future cash flows. Future cash flows are usually forecast for at least five to 10 years, then brought back to today's dollar by applying a discount rate.

In some industries, formulas are used to value an entire business. These formulas develop over time and tend to reflect a typical buying pattern in the industry, without regard for the quality of the company. These "rule of thumb" valuations measurements allow the industry participants to begin discussions regarding a transfer, but the rules are not definitive. Industry formulas are not replacement for the sound financial analysis, and should not be used to make valuation decisions.

Minority Interests

Valuing a minority interest in a privately-held company represents a typical valuation problem. Most laymen believe that a minority stock interest is worth the proportion share of the assets of the corporation. In fact, due to lack of control and poor marketability, minority interests are typically valued at far less than proportionate share of the assets.

Typically, minority interests are valued by direct comparison with other sales of minority interests. The main source of comparative minority interest data are the stock traded of minority interests of publicly-traded companies. This direct comparison results in a value as if publicly traded.

To apply this approach to a minority interest in a private company normally requires applying a discount for lack of marketability. It is intuitive that private shares do not enjoy the ready marketability of their public counterparts. Studies have shown this lack of marketability can discount the private minority stock's value up to 50 percent and more in some cases.

Valuing a controlling interest, on the other hand, requires accounting for the additional value inherent in the control interest. This value is most apparent when such an interest is purchased in a large company. Studies by Houlihan, Lokey, Howard & Zukin, Inc., a firm that measures control premiums, show that the average control premium paid over the past decade have exceeded the 30 to 40 percent range.

Ultimately, each valuation must be customized to a particular set of circumstances ---- it's not a "one size fits all" matter. I only want to reinforce the notion that "book value" and other cost approaches are not suitable for most valuations, and that professional standards for business appraisal do exist.

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